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EX PARTE OR LATE FILED

January 10, 2000

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BY HAND

Magalie R. Salas, Esq.
Secretary
Federal Communications Commission
The Portals
445 Twelfth Street, S.W.
12th Street Lobby, TW-A325
Washington, D.C. 20554

Re: *CC Docket No. 98-184; Ex Parte Filing*

Dear Ms. Salas:

Enclosed are two copies of a written *ex parte* to be filed on the public record in the above-referenced docket. By copy of this letter, I am hand delivering this document to the persons listed below.

If you have any questions, please contact me.

Very truly yours,

Steven G. Bradbury

Steven G. Bradbury

SGB:pd

cc (w/encl.): Dorothy Attwood, Esq.
Christopher Wright, Esq.
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January 10, 2000

SUPPLEMENTAL *EX PARTE* SUBMISSION OF GTE/BELL ATLANTIC

GTE/Bell Atlantic submits this paper as a follow-up to our written *ex parte* of January 4, 2000, in which we described our proposal to transfer GTE-I to a new public corporation ("DataCo") of which the merged GTE/Bell Atlantic ("NewCo") will own 10% with an option to increase its ownership in the future to 80%. This paper explains why, under our proposed structure, NewCo will not "own an equity interest (or the equivalent thereof) of more than 10 percent" in DataCo, within the meaning of section 3(1) of the Act, unless and until NewCo exercises its option.

Discussion

The definition of "affiliate" in section 3(1) of the Communications Act states:

> The term "affiliate" means a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person. For purposes of this paragraph, *the term "own" means to own an equity interest (or the equivalent thereof) of more than 10 percent.*

47 U.S.C. § 153(1) (emphasis added). Three points are essential to the proper application of the 10% ownership ceiling here:

First, affiliate status under section 3(1) depends on *current* equity ownership interests, not on the right to acquire equity ownership in the *future* (as through an option or other conversion rights);

Second, consistent with the statute's focus on ownership and control, the 10% determination turns on the proportionate share of equity interest currently owned, not on the fair market value of the assets contributed to the corporation; and

Third, it is common for the value of a publicly traded stock to be depressed by the value attributed to a fixed-price option or other conversion right or by the existence of an executory contract to buy the corporation at a negotiated price, and such a result *does not decrease* the percentage ownership held by the public stockholders.

These points confirm that DataCo will not be an "affiliate" of NewCo pending 271 relief, since NewCo will own a current equity interest in DataCo of no more than 10%, notwithstanding its valuable conversion rights.

A. Options and Other Rights To Acquire *Future* Equity Interests Do Not Count As Ownership Interests in Determining Affiliate Status Under Section 3(1).

Section 3(1) is written in the present tense ("owns," "is owned," "is under common ownership"). The plain terms of the statute thus indicate that only *current* ownership interests, as opposed to *future* interests like options and other conversion rights, are to be taken into account in determining compliance with the 10% ownership ceiling. This reading is borne out by Commission precedent directly on point.

In *In re Time Warner Cable*, 12 FCC Rcd 23363 (1997), the Commission expressly ruled that options and other conversion rights are to be *excluded* in determining whether a person "own[s] an equity interest (or the equivalent thereof) of more than 10 percent" under section 3(1). In *Time Warner Cable*, the Commission determined that CAI Wireless, a multichannel video programming distributor, was not an "affiliate" of Bell Atlantic under section 3(1) even though Bell Atlantic owned "7,000 shares of CAI Senior Preferred Stock, which are unilaterally convertible into shares of CAI Voting Preferred Stock, which are then unilaterally convertible into shares of CAI Common Stock." *Id.* ¶ 4. There was no dispute that Bell Atlantic had the right to convert its preferred shares into voting shares at will, and that such a conversion would give it a greater than 10% ownership interest in CAI. Nevertheless, the Commission agreed that "debt and instruments such as warrants, convertible debentures, options or other non-voting interests with rights of conversion to voting interests" do not count as equity interests "unless and until conversion is effected." *Id.* ¶ 8 (quotation marks omitted). The Commission concluded that "CAI should not be treated as a LEC affiliate." *Id.* ¶ 18.

This approach follows directly from the Commission and MFJ precedents cited in GTE/Bell Atlantic's written *ex parte* submission of January 4, 2000. While the MFJ barred a BOC from owning *any* interest in a firm engaged in a prohibited line of business – a standard more strict than the Act, which permits 10% equity ownership – the Commission in *In re Tel-Optik Ltd.*, 1 FCC Rcd 742 (1986), *aff'd*, 2 FCC Rcd 2276 (1987), held that NYNEX could acquire a fixed-price option in a firm providing a prohibited service. Likewise, Judge Greene repeatedly permitted BOCs to acquire options or other conditional interests in prohibited businesses. *See* January 4 *Ex Parte* at 6-9. Neither the Commission nor Judge Greene could have approved BOC acquisition of these options if they qualified as ownership of equity interests for regulatory purposes.

Likewise, the Commission has frequently distinguished current equity interests from contingent interests, characterizing options as nothing more than "potential future equity interests." *Biennial Review of Spectrum Aggregation Limits*, Report and Order, WT Docket No. 98-205, ¶ 8 (Sept. 22, 1999) ("securities affording potential future equity interests (such as warrants, options, or convertible debentures) are not considered attributable until they are converted or exercised"). *See also In re Woods Communications Group*, 12 FCC Rcd 14042,

¶¶ 13-14 (1997) (characterizing options as "future equity holdings" and "possible equity interests"). This approach is consistent with the contingent nature of options or other conversion rights under accounting principles. Although classified for standard accounting purposes as "equity securities," which often have market value in their own right, such instruments represent merely the "right to acquire" an equity ownership interest in the future; they do *not* represent current "ownership shares" in a corporation, which are represented by "common, preferred, and other capital stock." Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 12, ¶ 7(a) (Dec. 1975) (hereinafter "FASB 12").

In sum, an option, no matter what its value, does not qualify as a current equity interest. Accordingly, as established in *Time Warner Cable*, and as required by the plain language of the statute, the Commission does not consider such future interests in determining compliance with the 10% ownership ceiling of section 3(1).

B. The Decisive Factor Is the Amount of Equity Interest Currently Owned By NewCo, Not the Value of the Assets Contributed to DataCo.

The test of affiliate status under section 3(1) is ownership or control. Consistent with the statute's overall emphasis on ownership and control, the permissible 10% ceiling is measured by the share or percentage of the equity interest currently owned by a person, not the value of assets contributed to the corporation.

The proportionate equity interest held by shareholders is distinct from the *value* of the corporation's residual assets in which the shareholders have an interest. The traditional definition of equity interest is "[t]he stockholders' interest in the assets of a corporation after all indebtedness has been provided for." 19 Fletcher's Cyclopedia of the Law of Private Corporations, Glossary (perm. rev. ed 1995) (hereinafter "Fletcher's Cyclopedia"). The ownership of a current equity interest turns on traditional, well-established factors. Ownership, or "proprietary," interests in a corporation are divided into units or shares of stock. 11 Fletcher's Cyclopedia § 5081 ("Shares of Stock: Units of Proprietary Interests") (quoting Model Business Corporation Act). *See also* FASB 12 ¶ 7(a) (identifying "common, preferred, and other capital stock" as those "[e]quity securit[ies]" that "represent[] *ownership shares*") (emphasis added).

The three formal indicia of equity ownership represented by stock (*i.e.*, the "proprietary interests" held in a corporation) are "(i) a right to exercise some control over the corporation's management [*i.e.*, voting rights], (ii) a right, upon dissolution, to share in any residual proceeds from liquidation of the assets, and, *most important*, (iii) a right to share in the corporation's residual earnings [*i.e.*, any distribution of profits through dividends]." 11 Fletcher's Cyclopedia § 5081 (citing authorities) (emphasis added). *See Paulsen v. Commissioner*, 469 U.S. 131, 137 (1985) ("equity characteristics" of shares include "the right to vote on matters" related to management, the right to "receive dividends . . . paid out of net earnings," and the "right to a *pro rata* distribution of any remaining assets after a solvent dissolution").

Here, the public shareholders of DataCo will hold 90% of the voting rights in DataCo and will be entitled to receive 90% of any dividends or other economic returns derived from DataCo during the period before NewCo exercises its option. NewCo will have only 10% of the voting rights and will be entitled to receive only 10% of any interim dividends or other economic returns. Accordingly, NewCo will not "own an equity interest" in DataCo of more than 10% under the traditional indicia of current equity ownership.

Certainly, the assets contributed to DataCo by NewCo through the transfer of GTE-I will represent a valuable part of DataCo's total assets.[1] However, the relative value of assets contributed to a corporation by different classes of shareholders does *not* necessarily determine the proportional equity interest that each class currently owns. It is the share of current equity interest owned, as determined by the traditional indicia of stock ownership, that is the critical factor under section 3(1) of the Act.[2]

Under our proposal, NewCo will not receive in return for its contribution of GTE-I an immediate ownership interest that is proportionate to the size of its contribution. NewCo will receive full and valuable consideration for the transfer of GTE-I, but that consideration will take the form of a 10% immediate ownership interest in DataCo and a right to acquire a greater equity interest *in the future*, upon receiving 271 relief. As the following section makes clear, NewCo's

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[1] In the present case, the total amount of DataCo's assets in which the shareholders will have an equity interest, as shown on DataCo's financial statements, will be the amount of cash contributed by the public shareholders plus the book value of GTE's historical investment in GTE-I, less the debts owed by DataCo.

[2] The only context where the Commission has considered asset contributions in evaluating corporate ownership is under the foreign ownership benchmark of section 310(b)(4), but the Commission's approach there only confirms the importance of the traditional indicia of equity ownership. Section 310(b)(4) prohibits a foreign corporation from owning more than 25% of a licensee's "capital stock," and the Commission has determined capital stock ownership by the right to receive "profits and losses" and residual proceeds upon "sale or dissolution." *Fox Television Stations, Inc.*, 10 FCC Rcd 8452, at ¶ 50 (1995) ("*Fox I*"); *see also Fox Television Stations, Inc.*, 11 FCC Rcd 5714, at ¶ 15 (1995) ("*Fox II*"). These are the essential indicia of "beneficial ownership of the corporation." *Fox I*, ¶ 47; *see also Fox II*, ¶¶ 14-15. The foreign entity at issue in *Fox* held the right to receive 99% of any distribution of profits and 99% of any residual proceeds from liquidation, both of which matched its 99% capital contribution. *Fox I*, ¶ 50; *Fox II*, ¶¶ 15, 18. Only in such circumstances, where the contribution of the foreign entity *carried with it two of the three traditional indicia of equity ownership*, did the Commission conclude that asset contributions should be considered.

right to acquire a future equity interest does not diminish the current ownership interest held by the public shareholders.

C. It Is Common For the Value of a Stock To Be Depressed By the Acquisition Rights of Option Holders and Other Prospective Acquirers, But That Does Not Reduce the Proportionate Ownership Interest Represented By the Stock.

Prudent investors will invest an amount of money in stock that fairly reflects the benefits they expect to receive in return for their investment. Under our proposed structure, the public investors will expect to own a 90% voting and economic interest in DataCo, but only for a temporary period of time – that is, only until NewCo exercises its conversion rights (within five years from closing) – after which time, the public shareholders' ownership interests and attendant voting and economic rights will step down to 20%. Because prudent investors will factor in the probability and likely timing of NewCo's exercise of its option, they will likely value their investment on the assumption that they hold 90% of DataCo for a period of years and 20% thereafter. As a result, the IPO of public shares in DataCo can be expected to generate a capital contribution that is less than 90% of the fair market value of DataCo's business, but probably more than 20%.

This valuation of DataCo's public stock will reflect the normal and expected operation of the public markets, and will not mean that the public shareholders "own an equity interest" of less than 90% before exercise of NewCo's option. NewCo's option itself has value, and the likelihood that it will be exercised in the future sets a natural limit on the market price of DataCo's publicly traded shares. This result is common to every circumstance where a party holds an option to purchase property, and it does not mean that NewCo will have a greater-than-10% *current* ownership interest. For example, if NewCo owned an option to purchase a million-dollar piece of real estate for $100, that property would sell (subject to the option) for far less than $1 million (*i.e.*, for an amount reflecting the likelihood the option will be exercised and the time value of holding the property in the interim). Although the reduction in market value would reflect the value of NewCo's option, the option nevertheless would not give NewCo an equity interest in the property until exercised. *See, e.g., Martin v. Schindley*, 442 S.E.2d 239, 241 (Ga. 1994) ("An option to purchase land does not, before acceptance, vest in the holder of the option any interest, legal or equitable, in the land."); *Thacher v. Weston*, 83 N.E. 360, 361 (Mass. 1908) (the holder of option to purchase real estate has no ownership interest in the property).

To understand the economic and business results of our structure, it may be useful to compare several technically different, but in economic substance identical, approaches that we might have taken. Perhaps most straightforward would be a transaction in which (i) NewCo contributes GTE-I to DataCo in exchange for, let us suppose, 9 shares of DataCo common stock, (ii) simultaneously the public shareholders contribute cash to DataCo for 81 shares of DataCo common stock and (iii) the public shareholders give NewCo an option to acquire 63 of those shares, for nominal consideration, upon receipt of section 271 approvals. Under those facts, it would be clear that the public owns 81 shares out of 90 (or 90%) until the option is exercised and that NewCo owns 9 shares out of 90 (10%) plus the option. Equally, it would be clear that following exercise NewCo would own 72 shares out of 90 (80%) and the public would own 18 shares out of 90 (20%). This has exactly the economic result we have been discussing. However, it is not practical or tax efficient to receive an option from millions of public shareholders.

Accordingly, the transaction must instead be structured so that the contingent right is obtained directly from DataCo. One possibility would be a transaction in which (i) NewCo contributes GTE-I to DataCo in exchange for 2 shares of DataCo common stock plus an option to acquire, from DataCo, an additional 70 shares and (ii) simultaneously the public shareholders contribute cash to DataCo for 18 shares of DataCo common stock. Under those facts, it would be clear that the public owns 18 shares out of 20 (or 90%) until the option is exercised and that NewCo owns 2 shares of out 20 (or 10%) plus the option. Equally it would be clear that following exercise NewCo would own 72 shares out of 90 (80%) and the public would own 18 shares out of 90 (20%). The total number of shares outstanding prior to exercise is 20 rather than 90 for the simple reason that the option is exercisable for new shares, and thus the optioned shares will not be outstanding prior to exercise. Phrased differently, the 20 shares outstanding prior to exercise (2 held by NewCo and 18 by the public) represent 100% of the outstanding equity prior to exercise but only 20% on a fully diluted basis: the exercise of the option will dilute both NewCo's 2 shares and the public's 18 shares, and thus the presence of the option reduces the value of both holdings.

The above structure, too, has exactly the economic result we have been discussing. For tax reasons, however, rather than receiving a separate option to acquire additional shares from DataCo, it is important that NewCo receive a class of stock with a conversion right – in effect an embedded option. Accordingly, the structure contemplates a transaction in which (i) NewCo contributes GTE-I to DataCo in exchange for 2 (or some other number) of shares of DataCo Class B common stock that, by the terms of the corporate charter, represent 10% of the outstanding equity but have embedded in them a conversion right or option under which they may be exchanged for or converted into 72 shares of DataCo Class A common stock and (ii) immediately thereafter DataCo issues, in an initial public offering, 18 shares of DataCo Class A common stock for cash. This structure is identical in every way to, and leads to the same economic results as, the preceding two structures (although it has far more salutary tax consequences).

In short, in all three cases the public owns stock representing 90% of the equity prior to exercise of the option and NewCo owns stock representing 10% of the equity at such time, together with a contingent future right – an option or conversion right – to obtain from someone (the public in case one and DataCo in cases two and three) stock that will increase its holdings to 80%. Where that option or conversion right is a right against DataCo, it creates an "overhang" that the market will recognize in valuing the outstanding stock.

This result is common in the market valuation of stock where fixed-priced options or warrants are involved. For example, a similar situation occurs when a company has publicly traded warrants outstanding that are "in the money" – that is, that have an exercise price below the value of the underlying stock. While those warrants do not, until exercised, represent an ownership interest in the stock or equity of the company, they clearly impact the value of the stock or equity that is outstanding for the simple reason that the market "knows" that they will likely be exercised and, in consequence, that the equity of the company will ultimately have to be shared with the warrant holders. Notwithstanding that, warrant holders are not treated as, or accorded the rights of, stockholders prior to exercise – they have no voting rights, the directors do not owe them fiduciary duties, and they do not participate in dividends.

The very same market phenomenon commonly occurs where the corporation has entered into an executory contract to be acquired by another corporation at a negotiated price, particularly one that involves the exchange of the acquirer's stock at a set ratio for the target's shares. In such cases, once the shareholders believe that the acquisition will go forward, it is common for the target corporation's stock price to track the acquisition price or exchange ratio set forth in the purchase contract. Nevertheless, the shareholders continue to "own" all of the equity interest of the target corporation until such time as the acquisition is consummated.

Conclusion

The three points discussed above, taken together, are sufficient to confirm that under the proposed structure we laid out in our January 4 *ex parte* submission, DataCo will not be an "affiliate" of NewCo because NewCo will not "own an equity interest (or the equivalent thereof) of more than 10 percent" in DataCo pending 271 relief.